



## MEMORANDUM

To: Members of the Investment Subcommittee of the Cash Management Policy Board  
From: Colleen C. Davis, State Treasurer  
Date: April 15, 2020  
Subject: Investment Architecture Review and Proposed Amendments

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### SUMMARY

On February 28, 2018, the Cash Management Policy Board (“the Board”) adopted the current investment architecture, as memorialized in Resolution 2018-1(appendix). As of April 1, 2020, the State’s liquidity and reserve managers have had their portfolios positioned to reflect this current architecture for two years. In this time, the Office of the State Treasurer (“OST”) and the Board have had the opportunity to become more familiar with the operational nuances of the architecture and critique its strengths and weaknesses.

OST regards Resolution 2018-1 and its appendix as key operational documents. As credit markets move into a distinctly different economic climate than the one in which the architecture was created and adopted, it would be prudent for the Board to review Resolution 2018-1 and consider several amendments to provide additional clarity and corrections where needed.

This memorandum suggests three amendments to the Board’s investment architecture. The first would set target allocations for liquidity and reserve accounts based on percentages of the State’s overall investment portfolio, not fixed dollar amounts. The second proposed amendment would change the way draws are made from reserve accounts and bring clarity to the Board’s loss-mitigation strategy. The third and final change would identify the specific reserve manager or managers that will hold certain restricted funds within the portfolio.

### AMENDMENT 1: RESTATE ALLOCATION AMOUNTS AS PERCENTAGES

#### *Background*

The investment architecture memorialized in Resolution 2018-1 is based on NEPC’s 2017 study of historical cash flows. NEPC found that the historical average balance of the portfolio in the preceding 10 years was \$1.6 billion. Additionally, NEPC analyzed seasonal cash flow trends and found that the State could meet its cash needs using incoming revenues and periodic draws of up to 25% of the State’s overall investment portfolio. NEPC therefore suggested a 25/75 (liquidity/reserve) split to minimize draws from the longer-dated reserve portfolios.

The investment architecture included initial target allocations for each liquidity and reserve manager. The allocation amounts were nominal dollar amounts (tied to the \$1.6 billion historical average balance of the portfolio), rather than set percentages of the overall portfolio balance. The investment architecture gave OST discretion to modify the allocation amounts by up to 10%.

Due to robust tax collection in 2018, allocations in the liquidity portfolio exceeded the stated allocation amounts almost immediately after the adoption of the new architecture. The Board opted not to rebalance the portfolios at that time and instead directed OST to hold excess funds with the liquidity managers. The Board effectively adopted a wait-and-see approach to determine whether liquidity accounts would revert to the \$ 400 million historical mean and whether the overall portfolio would revert to the \$1.6 billion historical mean.

In May 2019, the Board directed OST to transfer excess cash from the liquidity accounts to the reserve accounts following any month in which aggregate liquidity balances exceed 30% of the total portfolio balance, reflecting the 25% allocation with a 5% buffer.

In the 24 months since the adoption of the investment architecture, there have been no reserve draws, only transfers of excess cash from liquidity to reserve accounts. The total portfolio has maintained baseline liquidity balances of 17% or better during the recent 24 months.

*Proposal*

Amend the investment architecture to set target allocations based on percentages rather than nominal dollar amounts. This change will allow the portfolio to dynamically adjust based upon actual cash flows, liquidity and reserve balances, and changes in the market environment.

**AMENDMENT 2: REFINE RESERVE DRAW GUIDANCE**

The investment architecture established a four-tiered regime for the management of reserve accounts, with each tier having its own duration mandate. In the event reserve draws become necessary, the investment architecture requires OST to draw first from the lowest-numbered available tier, followed by the next lowest tier once the first tier is exhausted. OST was also given discretion to draw from reserve accounts without regard to tier numbers in order to minimize losses. No reserve account draw has been made since the adoption of the investment architecture.

OST believes that it may make sense to revisit the rules for reserve draws and bring clarity to the scope of OST's discretion to disregard the tier structure to avoid losses.

*Proposal*

Amend the reserve account guidance to either (a) eliminate the lowest tier first guidance, in favor of a strict loss-minimization approach, or (b) retain current guidance and add a loss threshold for when loss-minimization should take precedence over tier preference.

**AMENDMENT 3: MEMORIALIZE RESTRICTED AMOUNTS**

The State's portfolio consists largely of co-mingled general and special funds. There are, however, at least two restricted funds that warrant special treatment in the investment architecture.

The first such restricted fund is the State's Budget Reserve Account provided for in art. VIII, § 6 of the Delaware Constitution of 1897. The Budget Reserve Account may not be drawn upon absent a 3/5 vote of the members of each house of the General Assembly. Per a footnote in the investment architecture, this fund is deemed to be held exclusively by JP Morgan, the incumbent tier 1 reserve account manager. OST believes it may make sense for the Board to revisit where the Budget Reserve Account resides within the investment architecture.

The second restricted account is the Budget Stabilization Fund first established by Governor Carney's Executive Order 21 and subsequently memorialized by the General Assembly in epilogue language in the fiscal year 2020 budget bill. This fund also requires an act of the General Assembly as a condition to any draw. This fund presently is not accounted for within the investment architecture.

OST notes that the Budget Reserve Account has never been drawn upon in the 40 years it has existed. OST believes that the General Assembly would authorize draws on the Budget Stabilization Fund before granting access to the Budget Reserve Account.

*Proposal*

Revise the investment architecture to memorialize the placement of both of the restricted accounts within the reserve account structure.

## APPENDIX

### DELAWARE CASH MANAGEMENT POLICY BOARD RESOLUTION NO. 2018-1 AMENDING INVESTMENT ARCHITECTURE FOR THE STATE'S CASH ACCOUNTS<sup>1</sup>

**WHEREAS**, the Delaware Cash Management Policy Board (the “**Board**”) is authorized and empowered by 29 *Del. C.* § 2716(a) to establish policies (a) for the investment of all money belonging to the State of Delaware (the “**State**”) or on deposit from its political subdivisions, except money deposited in any State pension fund or deferred compensation program, and (b) to determine the terms, conditions and other matters relating to the investment of State Funds, including the designation of permissible investments, the allocation between short- and long-term investments, the selection of investment managers (“**Managers**”) and the allocation of funds among the Managers;

**WHEREAS**, the Board has promulgated investment objectives and guidelines for the investment of State Funds, as memorialized in 1 *Del. Admin. C.* § 1201 (the “**Guidelines**”);

**WHEREAS**, under the Guidelines, unless otherwise determined by the Board, the Office of the State Treasurer (“**OST**”) has discretionary authority to allocate State Funds among the Cash Accounts in accordance with the general purposes of the Accounts and the investments objectives for those Accounts set forth in the Guidelines;

**WHEREAS**, the Guidelines do not expressly prescribe (a) the specific amounts or percentages of State Funds that must remain in the Cash Accounts, (b) the number of Liquidity or Reserve Accounts that will be maintained to manage State Funds, (c) the number of Managers that are required or authorized to provide investment services for the Liquidity and Reserve Accounts, or (d) the benchmarks or benchmark proxies that will be used by OST and the Board to assess the performance of State Funds and the Managers (“**Open Investment Issues**”);

**WHEREAS**, pursuant to Resolution No. 2017-1, the Board preliminarily approved an Investment Architecture addressing the Open Investment Issues to provide a more detailed framework for the investment of State Funds and facilitate a procurement process for investment management services;

**WHEREAS**, subsequent to the approval of the Investment Architecture, the Board and OST commenced a formal procurement process for investment management services and solicited proposals from firms desiring to provide such services to the State;

**WHEREAS**, in connection with the procurement process, the Board and OST invited the Board’s investment consultant and potential Managers to provide comments and suggest changes to the Investment Architecture;

**WHEREAS**, on January 11, 2018, at a special meeting of the Board’s Investment Subcommittee (the “**Subcommittee**”) at which a quorum of the members of the Subcommittee was present, the Subcommittee discussed various changes to the Investment Architecture proposed by the Board’s investment consultant and several prospective Managers;

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<sup>1</sup> Capitalized terms used but not defined herein shall have the meanings ascribed to such terms in the Guidelines or Resolution No. 2017-1, as appropriate.

**WHEREAS**, on February 7, 2018, at a regularly scheduled meeting of the Subcommittee at which a quorum of the members of the Subcommittee was present, the Subcommittee voted to recommend to the full Board certain of the proposed changes to the Investment Architecture, which approved changes are reflected in the amended Investment Architecture attached hereto as **Exhibit A** (the “**Amended Investment Architecture**”); and

**WHEREAS**, on February 28, 2018, at a regular public meeting of the Board at which a quorum of the members of the Board was present, the Board by unanimous vote approved the Amended Investment Architecture and the form of this Resolution;

**NOW, THEREFORE, BE IT RESOLVED BY THE BOARD:**

1. The Amended Investment Architecture is approved and adopted by the Board, effective as of March 1, 2018 (the “**Effective Date**”); provided, however, Mangers shall have until April 2, 2018, to bring their portfolios into compliance with the Amended Investment Architecture.
2. OST and its officers and employees are authorized and directed to take such action as may be necessary or appropriate to effectuate or carry out the purpose and intent of this Resolution, including, without limitation, any action that may be necessary to formally revise the Guidelines if and as necessary under Chapter 101 of Title 29 of the Delaware Code, and the execution and delivery of any documents, instruments, agreements or amendments as may be necessary, advisable or appropriate to implement the Investment Architecture, and the taking of any such action shall conclusively evidence the appropriateness or necessity of any such documents, instruments or agreements.
3. The Board reserves the right, whether prior to or after the Effective Date, to make any changes to the Amended Investment Architecture that it believes are in the best interest of the State.
4. All acts, transactions or agreements undertaken prior to the adoption of this Resolution by any member of the Board or any officers or employees of OST in connection with the matters authorized by this Resolution and all actions incidental thereto are hereby ratified, confirmed and adopted by Board.

**Adopted by the Cash Management Policy Board  
on February 28, 2018**

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John Flynn, Chairperson

ATTEST:

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Ken Simpler, State Treasurer  
& Board Member

## **EXHIBIT A**

### **AMENDED INVESTMENT ARCHITECTURE FOR CASH ACCOUNTS**

The following Amended Investment Architecture shall govern the management of the State's Cash Accounts. The Investment Architecture is intended to provide the Office of State Treasurer ("OST") and the Managers of such Accounts with a flexible framework to maintain the safety and availability of State Funds to meet the State's immediate and intermediate funding needs and maximize the return on State Funds. Capitalized terms used but not defined herein shall have the meanings ascribed to such terms in the Guidelines or Board Resolution No. 2018-1, as appropriate.

#### **I. Allocation Among Cash Accounts**

The Investment Architecture contemplates that, on an annual average basis, (a) approximately \$100 million of State Funds will be held in Collection and Disbursement Accounts and used to meet the State's anticipated near-term operating requirements, (b) approximately \$400 million of State Funds not needed for near-term operating requirements will be held in Liquidity Accounts and used to meet anticipated funding needs of the State and (c) approximately \$1.2 billion of State Funds will be held in Reserve Accounts and made available if an as needed to satisfy the State's unanticipated funding needs.

#### **II. Allocation Among Liquidity Accounts and Managers**

There shall be two (2) Liquidity Accounts, each with its own Liquidity Manager. State Funds in the Liquidity Accounts will be allocated to two (2) Liquidity Managers. Each Liquidity Manager may receive allocations and manage State Funds totaling up to approximately \$200 million on an annual average basis. The Liquidity Accounts will be managed in accordance with sections 4 and 6 of the Guidelines.

OST may in its discretion draw on State Funds in one Liquidity Account or both Liquidity Accounts to meet anticipated funding needs within a given fiscal year. Discretionary draws normally will be made on a pro rata basis. One or both of the Liquidity Accounts may be completely liquidated during certain periods of the fiscal year.

OST shall have discretion to replenish the Liquidity Accounts as revenues are received throughout the fiscal year. Refunding of the Liquidity Accounts normally will be made on a pro rata basis.

#### **III. Allocation Among Reserve Accounts and Managers**

There shall be three (3) "Tiers" of Reserve Accounts, with each Tier having a unique investment duration target. The Tier 1 Reserve Account has a duration target of one (1) to three (3) years.<sup>2</sup> The Tier 2 Reserve Account has a duration target of one (1) to five (5) years. The Tier 3 Reserve Accounts have a duration target of five (5) to ten (10) years. There shall be two (2) Tier 3 Reserve Accounts, each with its own Reserve Manager.

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<sup>2</sup> The Tier 1 Reserve Account includes the "Budget Reserve Account" provided for in art. VIII, § 6 of the Delaware Constitution of 1897. The Budget Reserve Account has a present balance of approximately \$237 million (including a \$5 million cushion approved by the Board), which State Funds may not be drawn down by OST or used to satisfy unanticipated needs absent a 3/5 vote of the members of each house of the General Assembly.

State Funds in the Reserve Accounts will be allocated to four (4) Reserve Managers. Each Reserve Manager will manage an account in a specific Tier and may receive allocations and manage State Funds totaling up to approximately \$300 million on an annual average basis. The Reserve Accounts will be managed in accordance with sections 4 and 7 of the Guidelines.

In the event the State has unanticipated funding needs, draws from the Reserve Accounts should be made first from the lowest-numbered available Tier, except as noted below. When the lowest-numbered available Tier has been exhausted, OST may draw on and utilize State Funds in the Reserve Account with the next lowest-numbered available Tier. OST shall have discretion to draw from the Reserve Accounts, regardless of Tier number, to access cash or near-maturity investments in an effort to minimize losses or transactional costs.

OST shall have discretion to replenish the Reserve Accounts as revenues are received throughout the fiscal year. Refunding of the Reserve Accounts need not be made on a pro rata basis or with preference for any particular Tier.

#### **IV. Benchmark Proxies**

**Liquidity Managers.** None.

**Tier 1 Reserve Manager.** The Benchmark Proxy for the Tier 1 Reserve Manager shall be: 100% invested in Intercontinental Exchange Bank of America Merrill Lynch (“**ICE BofAML**”) 1- to 3-year government/corporate bonds rated “A” or better.

**Tier 2 Reserve Manager.** The Benchmark Proxy for the Tier 2 Reserve Manager shall be: 100% invested in ICE BofAML 1- to 5-year government/corporate bonds rated “A” or better.

**Tier 3 Reserve Managers.** The Benchmark Proxy for the Tier 3 Reserve Managers shall be: 100% invested in ICE BofAML 5- to 10-year government/corporate bonds rated “A” or better.

#### **V. Modification of Allocation Amounts**

The allocation amounts set forth herein are based on current Cash Account balances and revenue and expense projections and present economic conditions and may need to be modified to account for materially changed circumstances. OST shall have discretion to increase or decrease on a temporary or permanent basis any allocation amount provided that such change does not alter the allocation amount by more than 10 percent (10%). OST shall seek Board approval to increase or decrease any allocation amount by more than 10 percent (10%). OST may temporarily alter an allocation amount in excess of 10 percent (10%) on an emergency basis pending Board approval.